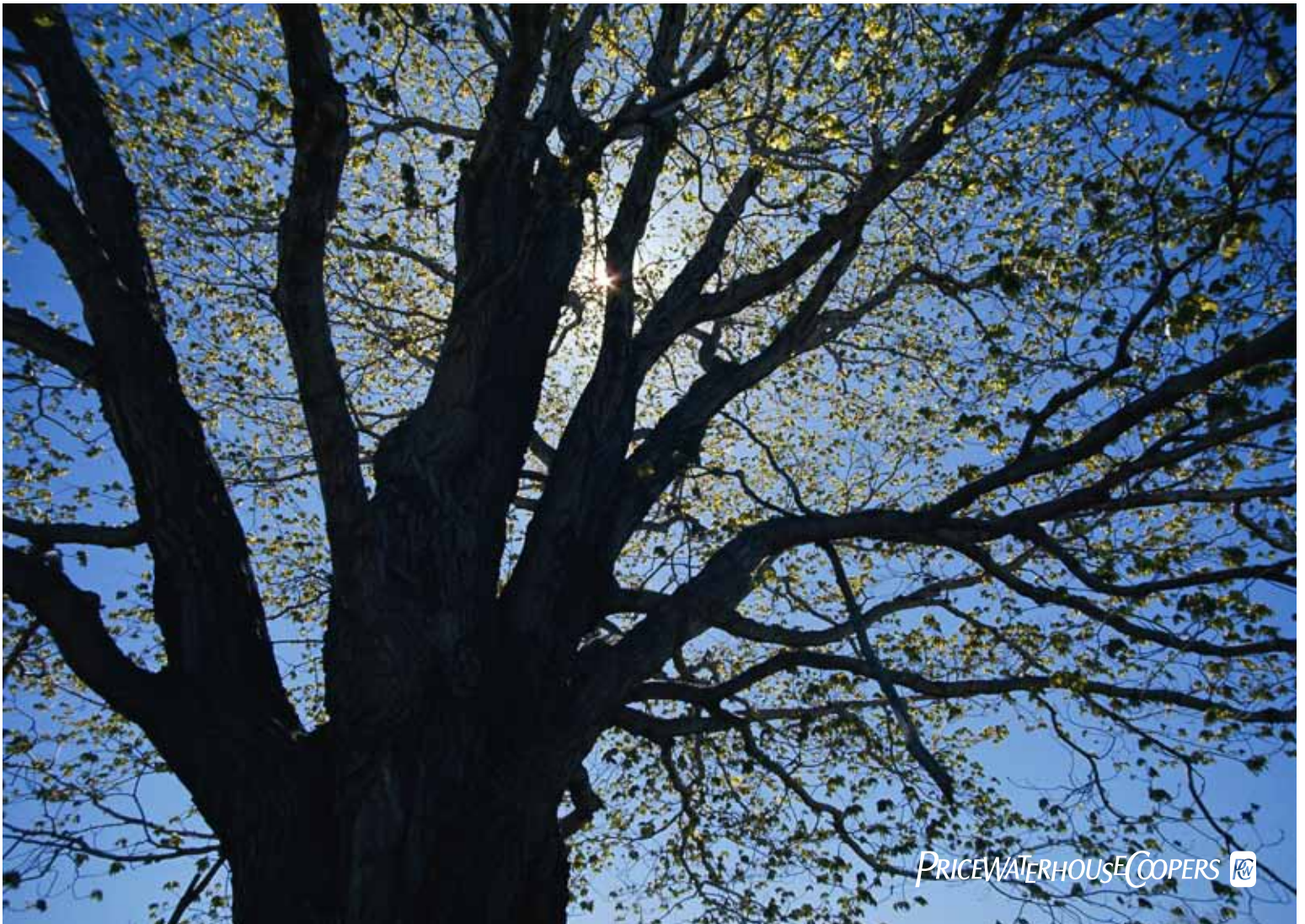


Blockbuster or Block-bust?  
Practical transfer pricing solutions in the world  
of high risk product investment decisions

# Transfer pricing perspectives

Re:solutions  
moving towards certainty



# Blockbuster or Block-bust? Practical transfer pricing solutions in the world of high risk product investment decisions<sup>1</sup>

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**Abstract:** Set in the context of current and emerging transfer pricing disputes, this article discusses the manner in which economic conditions, business opportunities, services, risks, and intangibles interact during the lifecycle of products (development, commercialisation, and end of product life); the transfer pricing implications of this interaction and best practices with emphasis on intangible property (IP) valuation; profit split analyses and new techniques for IP analysis; and migrations.

## Introduction

Major transfer pricing disputes often arise from conflicts or confusion of the prevailing concepts and analysis involving economic conditions, business opportunities, services, risks, and intangibles. By some measures, more than 50% of the US federal transfer pricing cases decided to date specifically deal with one or more of the above factors, which all interact during the lifecycle of products.<sup>2</sup>

**Figure 1: The Puzzle**



<sup>1</sup> This article is summarised based on the presentation prepared for the PwC 2008 Transfer Pricing Global Conference Technical Session held in Vancouver, Canada.

<sup>2</sup> Transfer Pricing Case Summary: Simplifying Complexity, PwC Internal Publication, 2008.

## **Economic conditions**

Although the important role that “economic conditions” play in transfer pricing analysis is acknowledged explicitly in US regulations, the guidelines set by the Organisation for Economic Co-operation and Development, and transfer pricing legislation, it is ignored or simplified in practice.

At any given time, intercompany transactions could take place under a wide range of conditions from perfect competition to pure monopoly.

Perfect competition usually is characterised by many buyers and sellers with equally small market share, perfect information, identical products sold in the market, and the absence of barriers to entry or exit in the long run. These firms may adopt a variety of market share strategies. In this environment, however, the precondition to create and sustain economic rent generally is low.

In a near perfect competition market (e.g., an oligopoly), there are usually only a limited number of sellers with significant and varying market shares and uneven access to resources. This situation may be associated with imperfect information and barriers to entry. Firms may differentiate their products through innovation, marketing, and advertising. In this environment, the precondition to create and sustain economic rent generally is moderate. Firms may achieve it by: lobbying for market regulations; preserving economic conditions; creating brand loyalty; maintaining/increasing innovation and information asymmetry; creating or extending barriers to entry and exclusive relationships; and increasing economies of scope, scale, and efficiencies.

In a market with a pure monopoly, only one seller holds complete market share and absolute access to resources. There is imperfect information and high or absolute barriers to entry. All these characteristics provide the monopoly firm with a high precondition to create and sustain long-term economic rents.

The economic conditions surrounding the intercompany transactions under analysis may lead to the creation of economic rent and thus influence the ability to gain access to business opportunities. Therefore, it is important to analyse the prevalent economic conditions of the taxpayer, which will provide critical information and economic evidence in a transfer pricing dispute.

## **Business opportunities**

Tax authorities have a keen interest in transfers of “business opportunity,” also known as profit potential. The desire to require compensation for the loss of business opportunity may or may not be consistent with prior advance pricing agreements, rulings, tax law, and transfer pricing practices in many jurisdictions, however.

For instance, in the United States, business opportunity is a concept of corporate law developed to impose a fiduciary duty on directors not taking for him or herself an opportunity to generate income. Instead, that income should be reported and given to the company. While current IRS positions on intangibles may not always be aligned, the seminal court decision on this issue in US tax law explicitly states that business opportunity is not a transferable intangible (Hospital Corporation of America case).<sup>3</sup>

In contrast, “lost business opportunity” is a long-standing concept in German civil code and is more established there. New transfer pricing rules in Germany stipulate a potential payment for a lost business opportunity.<sup>4</sup> Furthermore, an OECD working group on Business Restructurings is currently studying the issue.

## **Services**

Historically, tax authorities have taken a simplistic approach to evaluate routine/low-value and non-routine/high-value services. For example, tax authorities have deemed services to be non-routine whenever a service provider makes non-routine contributions. This has sometimes led tax authorities to believe that these services cannot be benchmarked and therefore the profit split method has to be applied. In reality, however, these high-value services can be measured. An example may be to compare some of these “high-value” services with asset management or investment advisory services (IAS). Those who work in IAS obtain capital from clients and invest it where appropriate. Furthermore, its employees earn salaries and bonuses but do not keep the returns on the capital they manage. In some instances, IAS may provide useful benchmarks. A number of PwC databases provide data on IAS fees that may be useful when analysing these types of intercompany transactions.

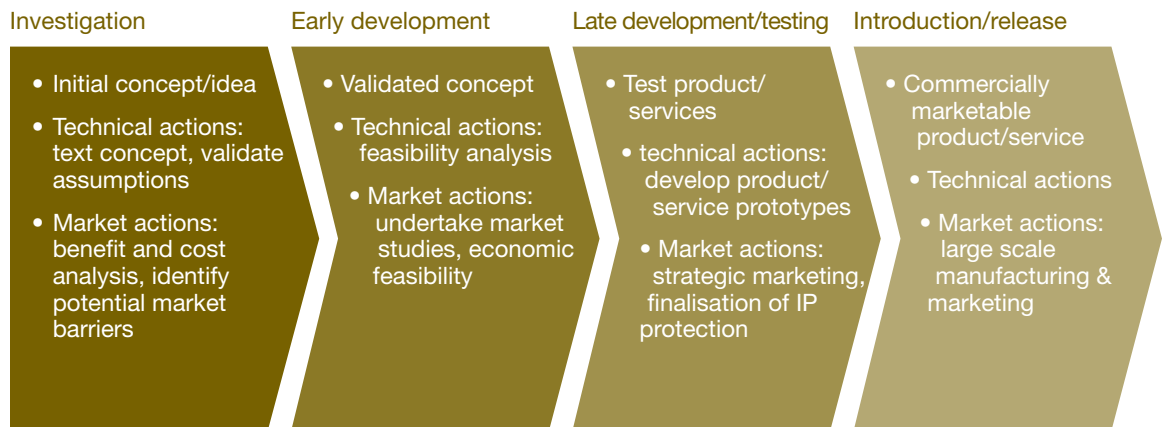
<sup>3</sup> Cost Segregation Audit Techniques Guide, Chapter 2, IRS, [www.irs.gov](http://www.irs.gov).

<sup>4</sup> Tax Reference Library No .35; Transfer Pricing (9th edition), International Tax Review.

## Risks

The concepts of economic conditions, business opportunities, and services should not be interpreted alone without considering the associated risks to which they are exposed under each phase of product development. To identify risks, each phase of product development has to be clearly specified and understood first. The classification of each phase varies from industry to industry. For example, in the pharmaceutical industry, there are preclinical trial phases and clinical testing phases, the latter of which can be further divided into Phase I, Phase II, and Phase III.<sup>5</sup> Meanwhile, product development for computer software typically is divided into five phases: analysis, design, coding, testing, and closing.<sup>6</sup> However, the various classifications could be generalised into one analytical framework, as shown in the figure below.

**Figure 2: General Analytical Framework for Product Development**



Traditional product development is managed in a closed, internally focused manner. Recent trends in product development point toward an open system with a far greater external focus. The all-inclusive traditional internal research and development (R&D) has become hard to justify in a world of dispersed ideas, abundant capital, and a mobile workforce.<sup>7</sup> Increasingly, companies are transforming their R&D groups into knowledge scouts and brokers.

Taxpayers are still free to arrange global affairs how they see fit. However, revenue authorities increasingly want to understand business rationale for development decisions and whether third parties might also follow open innovation strategies.

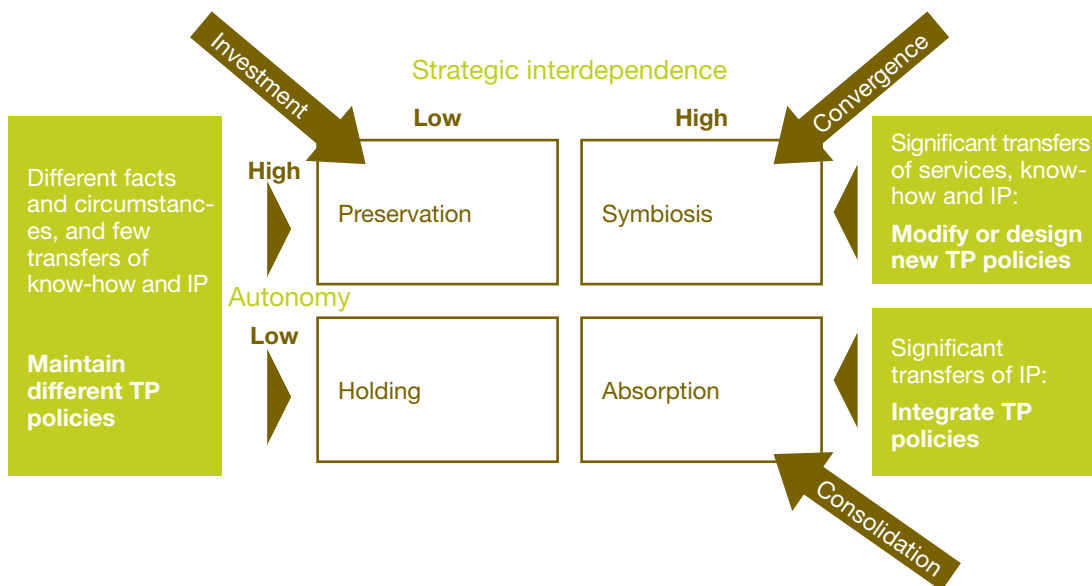
Investment strategies and firm interactions are driven by the various approaches to product development. Accordingly, transfer pricing models are influenced by the type of open innovation strategy adopted, as shown in Figure 3.

<sup>5</sup> DiMasi, J. A., R. W. Hansen, H.G. Grabowski, and L. Lasagna, (1991), "Cost of Innovation in the Pharmaceutical Industry," *Journal of Health Economics*, 10: 107-142.

<sup>6</sup> D. Kelly, "Software Test Automation and the Product Life Cycle," *MacTech*, Vol.13,1997.

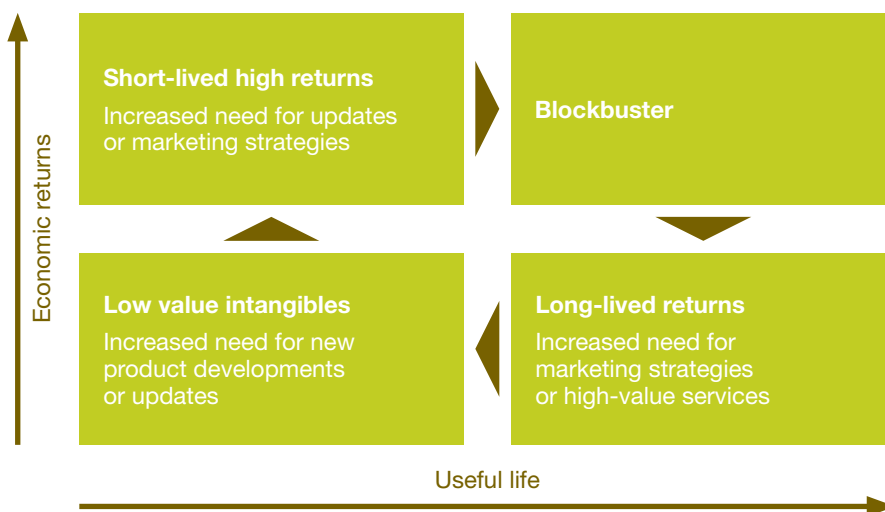
<sup>7</sup> H. Chesbrough, "Open Innovation," HBS Press 2003.

**Figure 3: Product development under open innovation:  
Different implications for transfer pricing analysis**



The results of the product development efforts depend on the length of useful life and economic returns of new products. As illustrated in Figure 4, if the economic returns are low and useful life is short, then the product development efforts may produce only low value intangibles, for which there is an increased need for new product development or updates to maintain the economic rent. If the economic returns are high but the useful life is short, then there are only short-lived high returns on the new products, for which there is an increased need for updates or marketing strategies. If the economic returns are low but the useful life is long, then there are long-lived returns on the new products, for which there is increased need for marketing strategies or high-value services. If the economic returns are high and useful life is long, then the product development has produced the ideal product: a blockbuster.

**Figure 4: Product development and useful life**



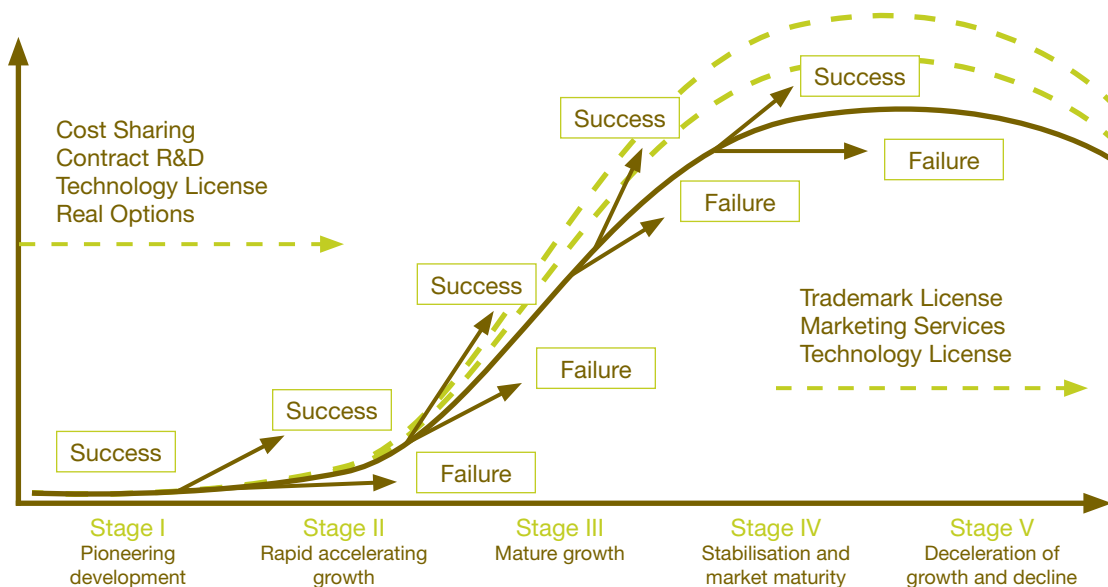
### Intangibles

There are alternative approaches to valuing intangible assets based on the degree of sophistication. Transfer pricing models may range from: a cost approach that estimates the value by determining the cost to build or replace the asset; income approach estimates value in terms of future cash flows to which the owner of the asset is entitled; market approach estimates the value by analysing the characteristics of recent sales of similar assets; flexibility approach couples discounted cash flows with decision tree analysis methods to increase flexibility; real options approach estimates value in light of changing market and economic conditions; or a combination of the above mentioned models for complex situations.

An integral component in the valuation of intangible assets is an estimation of their useful lives. Life analysis is the study of the placements of (or investing in) similar assets—and their subsequent retirements—in order to develop their life characteristics. Based upon an evaluation of these life characteristics, the remaining useful life of the surviving assets can be estimated.<sup>8</sup>

<sup>8</sup> R. Reilly and R. Schweih, "Valuing Intangible Assets," 2007, McGraw-Hill.

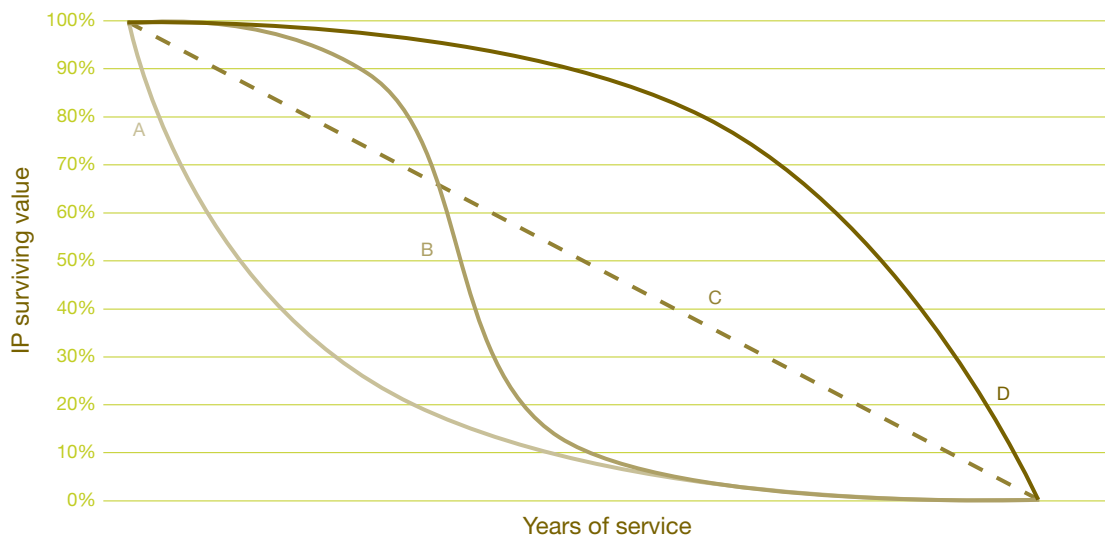
**Figure 5: Life cycles and valuation models**



There are eight determinants of the useful life of an intangible asset: legal life (or statutory life), contractual life, judicial life, physical life, technological life, functional life, economic life, and analytical life. Survivor curves are used to predict the average life and the remaining useful life of intangible assets. As time passes, the percentage of the intangible surviving value decreases. This creates a downward sloping survivor curve. A survivor curve can be any mathematical function of age that accurately depicts the intangible asset's decay.

Figure 6 illustrates four potential shapes of survivor curves. Statistical analysis may be used to determine the shape of the survivor curve most applicable to each type of product. These results vary by industry and can have a significant impact on the outcome of transfer pricing models (e.g., cost sharing, buy-ins, IP migration).

**Figure 6: Survivor curves potential shapes**



Often times, various types of intangibles are combined, and they play an important role in the generation of economic rents and excess profitability. This is especially the case with blockbuster products. Any modelling exercise must be based on a deep understanding of the facts, prevalent economic conditions, and value drivers. Certain factors have a significant effect on the outcome of any valuation exercise, including timing of migration, profit potential, risks, and useful life.

## Conclusions

Major transfer pricing disputes often arise from a misunderstanding or oversimplification of the interdependence of economic conditions, business opportunities, services, risks, and intangibles. The number and magnitude of disputes are growing exponentially and the complexities of these issues are causing some tax authorities to consider new transfer pricing legislation. At the same time, more and more companies are changing their business models to deal with rapidly evolving economic conditions and new business opportunities. To date, planning structures have tended to focus on isolated transactions and factors rather than adopting a holistic approach that takes into account high-value services, auxiliary or third party IP, changes in profit-potential, and other relevant economic conditions.

In an age of increased disputes, it is more important than ever to understand and analyse economic conditions, business opportunities, services, risks, and intangibles in order to establish compelling legal and economic evidence to support transfer pricing positions.

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